Supreme Court of the United States

OCTOBER TERM, 1970

No. ~~883~~ 70-28

UNITED STATES OF AMERICA,
Petitioner,

versus

EDNA GENERES, Wife of, and ALLEN H. GENERES,
Respondents.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit.

BRIEF FOR RESPONDENTS IN OPPOSITION.

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of
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INDEX

CITATIONS

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BRIEF FOR RESPONDENTS IN OPPOSITION.

QUESTION PRESENTED.

Whether taxpayer's loss resulting from his agreement to indemnify a bonding company's guarantee of the work of the construction company in which taxpayer was employed as a salaried officer and was a shareholder was "proximately related" to taxpayer's trade or business as corporate officer so that the loss was deductible as a business bad debt under Internal Revenue Code §166 (1954).

STATEMENT.

The basic facts as set forth in Petitioner's brief are not disputed by taxpayer, but the "Statement" is incomplete. Petitioner has omitted important facts pertaining to the nature of the business in which taxpayer was employed which demonstrate the correctness of the Fifth Circuit's decision on the merits and which make this case inappropriate for review by this Court. There were several shareholders of Kelly-Generes Construction Company, Inc., (Kelly-Generes). Respondent owned only 44% of the stock in Kelly-Generes Corporation, and his son-in-law, William F. Kelly, also owned 44%. Both of these men were officers of the corporation, both rendered services to the corporation and both received salaries from the corporation. Drawing on his years of experience in the contracting business, Mr. Generes rendered substantial advice and consultation, including reviewing bids and jobs which the company proposed to undertake, and he helped obtain financing and bonds for the corporation. Neither taxpayer nor Mr. Kelly was a major shareholder; each rendered different services to the corporation; and each received different salaries from the corporation (Generes, $12,000; Kelly, $15,000); although both of them owned the same investment interest in the corporation. During the entire history of Kelly-Generes Construction Company, taxpayer received no return on his shareholdings in the form of dividends, and no other return on his involvements with the company other than salary.

It is not disputed that taxpayer had as a "trade or business" being a corporate executive for Kelly-Generes. It is

also not disputed that taxpayer had another trade, for which he also received a salary, but there is no dispute here (and it has been so stipulated) that first, a taxpayer may have more than one trade or business, and second, that taxpayer here did have the trade or business of being a corporate executive for Kelly-Generes.

There are many additional facts which could become relevant if this Court should grant a Writ of Certiorari. Petitioner has asked to preserve the question whether the *facts* support the jury's finding even under the "significant motivation" test in the event this Court grants a Writ but affirms the propriety of the test applied below. Respondent as well, because of the crucial importance of facts to the outcome of any case, respectfully reserves the right to supplement further this "Statement" in the event that such Writ is granted.

REASONS FOR DENIAL OF THE PETITION FOR WRIT OF CERTIORARI.

The government claims that the Supreme Court's review of this case will resolve a conflict among the Courts of Appeals over the test to be used in determining whether a taxpayer's bad debt claimed as a deduction under Internal Revenue Code §166 (1954) was incurred in a manner "proximately related to the taxpayer's trade or business" under *Whipple v. Commissioner*, 373 U.S. 193 (1963) and Treas. Reg. §1.166-5(b)(2). But this is not the appropriate case for resolution of that conflict. Both the procedural aspects of this case and its facts make Supreme Court review for this purpose a waste of judicial effort: first, this

Court cannot on the record of this case find that the instruction to the jury complained of was prejudicial error regardless of whether the Court favors the "predominant motivation" or the "significant motivation" test; second, the facts of this case are such that no meaningful holding can result which will give clear content to either test ultimately to be approved by this Court. Taxpayer believes that writs were applied for by the government in this case solely because this is the only case to date the government has lost on appeal wherein the "significant motivation" test was even adverted to.

1. It must be emphasized that this was a jury case, and that the judgment was rendered on the jury's affirmative answer to this sole interrogatory:

> Do you find from a preponderance of the evidence that the signing of the blanket indemnity agreement by Mr. Generes was *proximately related* to his trade or business of being an employee of the Kelly-Generes Construction Company? (Emphasis added.)

Thus, the jury found the ultimate fact of "proximate relationship" as required by *Whipple*, *supra*, and Treas. Reg. §1.166-5(b)(2). The jury did *not* ultimately find as a fact that taxpayer's incurrence of the bad debt was "significantly motivated" by reason of his employment rather than his equity interest in the corporation, even though the judge's instructions included the significant motivation test. Thus, this case can be reversed or reversed and remanded *only if* the significant motivation test is found to be *prejudicial* error on the record, that is, only if no reasonable man could have found that Generes incurred the bad debt in a manner

that was not proximately related to Generes' employment as an officer of the corporation under *any* jury charge that was a refinement or elaboration of the "proximate relationship" rule. Taxpayer submits that such a reversal is an impossibility in view of the jury's obvious belief in Mr. Generes' testimony, in which he consistently reiterated that he signed the indemnity agreement giving rise to the bad debt purely in order to protect his salary, that his salary was his sole return from his involvement with the corporation, that his investment in the stock of the corporation was small, and that the stock paid no dividends. See extract of testimony reprinted in the Court of Appeals' opinion, 427 F.2d at 283, and in Appendix A to the United States' "Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit" (hereinafter cited as "United States 'Petition' ") at 18. In affirming the jury's finding of "proximate relationship," the Court of Appeals relied on the jury's belief of Generes' testimony: "While admittedly much of [Generes'] testimony was self-serving, the credibility and sincerity of the taxpayer, the assessment of which is undisputably a jury function, were decided in his favor." 427 F.2d at 283-84, United States' "Petition," Appendix A at 18-19.

Upon review, this Court must then take Generes' testimony as true, and this Court would find as well that all circumstantial evidence in the record as to Generes' motivation indicates the existence of the requisite "proximate relationship." Briefly summarized, the circumstances surrounding the incurrence of the bad debt as shown in the record were these: Kelly-Generes was in the construction business; the bonding company required Kelly and Generes individually

to guarantee the construction bonds which were necessary for the company to do business; Generes was actively involved in the affairs of the business in which he had a lifetime of experience and in which part of his duties was to advise on bids submitted for particular jobs; Generes was not a controlling shareholder of the corporation. Under the facts developed in the record, this Court could not find that the trial judge's use of the "significant motivation" charge was *prejudicial* error, and, therefore, any enunciation on these facts of a proper test for "proximate relationship" under Treas. Reg. §1.166-5(b)(2) would be mere dictum if this Court were to review this case.

This is so despite the dissenting opinion of Judge Simpson below, since Judge Simpson mistakenly assumed that no debt incurred by a shareholder-employee of a corporation could be proximately related to his employment if, without the incurrence of the taxpayer's obligation, the corporation would have gone out of business (Judge Simpson stated that the government was entitled to a judgment notwithstanding the verdict because "of the clear proof that Generes and Kelly were required to sign the endorsement in order for the corporation to engage in the construction business." 427 F.2d at 285, United States' "Petition," Appendix A at 21). No court has so construed the requirement of "proximate relationship" under either a "dominant and primary" motivation test or a "significant" motivation test, and indeed this Court in *Whipple*, *supra*, precluded such reasoning. In *Whipple*, the taxpayer was a shareholder in Mission Orange Bottling Company and was also its landlord. Mission Orange was supposed to pay rent to taxpayer. Taxpayer lent money which became bad debts to Mission

Orange to keep it in business (373 U.S. at 196). This Court nevertheless remanded the case for a determination of whether taxpayer's bad debts were "proximately related" (373 U.S. at 204) to his trade or business as Mission Orange's landlord. Clearly, then, under *Whipple*, to which even the predominant motivation test must defer, although incurrence of a debt by a shareholder is a *sine qua non* to the company's doing business, it cannot necessarily follow, as Judge Simpson assumed, that the debts must have been predominantly motivated by the shareholder's equity interest in the corporation. Nor does *Niblock v. Commissioner*, 417 F.2d 1185 (9th Cir. 1969), which sets out the predominant motivation test, support this reasoning.

Upon our facts, it cannot then be found that the use of the "significant motivation" charge was prejudicial error, and, since the case cannot properly be reversed on the ground for which the United States desires review, this Honorable Court should deny the petition for the writ of certiorari.

2. The factual nature of this case dictates as well a further reason for denial of the United States' petition. The difference between the two standards of proximate relationship becomes crucial only in cases where a shareholder-employee made a *loan* to the corporation, where the shareholder-employee was a *controlling* shareholder, and where the nature of the shareholder-employee's obligation resulting in his loss was not a usual and customary feature of the corporation's business. All these elements were present in each taxpayer's situation in each of the two cases initiating the split among the Courts of Appeals, *Niblock*, *supra*, and

Weddle v. Commissioner, 325 F.2d 849 (2d Cir. 1963). In such situations, a finding of proximate relationship (if the case is not tried to a jury where the taxpayer's credibility is irreversibly passed on) will depend only on the proper interpretation of the policy which the proximate relationship test is intended to reflect. In these situations the Courts of Appeals have split on the standard of "proximate relationship" because they differ over whether it is better to be liberal or restrictive in allowing a controlling shareholder to take deductions from income when the loss results from personal loans to his company where he employs himself. See the reasoning of the Court of Appeals in *Niblock*, *supra*, at 1187[1] and *Weddle*, *supra*, at 851.[2] Divergence in the

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[1] The Court of Appeals in *Niblock* interpreted the policy of *Whipple*, *supra*, as follows:

> ". . . . We disagree with the significant motivating factor test that was applied by the majority in Weddle v. Commissioner of Internal Revenue, 325 F. 2d 849, 851 (2 Cir. 1963). We believe that the only test that will inject sufficient certainty into the interpretation of Section 166, supra, is the dominant and primary motivation test that we have stated. We interpret thus the admonition of the Supreme Court in Whipple v. Commissioner of Internal Revenue, supra, 373 U.S., at page 202, 83 S.Ct., at p. 1174: 'Even if the taxpayer demonstrates an independent trade or business of his own, care must be taken to distinguish bad debt losses arising from his own business and those actually arising from activities peculiar to an investor concerned with, and participating in the conduct of the corporate business.'" *Niblock v. Commissioner*, 417 F.2d 1185, 1187 (9th Cir. 1969).

[2] The Court of Appeals in *Weddle* interpreted the policy of *Whipple* more liberally:

> "Some passages in the Tax Court's opinion, if read alone, might suggest that the court was proceeding on what we would regard as an erroneous view of the law, namely, that a taxpayer like Mrs. Weddle has the burden of proving that her 'primary' motivation was to protect the trade or business of corporate employment in order to be entitled to the deduction. That is not what is said either by the statute or by the Regula-

holdings of the appellate courts on this policy has, no doubt, made it difficult for the Internal Revenue Service to administer our tax law in the close case described above. But the present case is not a case where a definitive ruling on these delicately competing policies is needed or is indeed going to be useful to either the courts or the Service. This is so because the construction business is *sui generis*, as is recognized in every area of our law, and because this is not a close case, given the already-established policy of allowing the deduction where there is a proximate relationship between a shareholder-employee's bad debt and his employment in the corporation. Generes was not a controlling or even a majority shareholder in Kelly-Generes Construction Co. Generes was active in the affairs of the business in the scope of his employment as its officer. Generes' debt was incurred on an indemnity agreement with a bonding company, and by law bonds must be secured if a construction company is to do public contracting business, federal, state or municipal. A bonding company backing a corporation the size of Kelly-Generes will require personal indemnity agreements as a condition to its own risk of liability on the bonds. Upon these facts, it is clear that the shareholder-employee's loss on an indemnity agreement is proximately related by any standard to his employment if he is active in the business, as Generes was, and if it is one of his regular duties to enter into such indemnification agreements, as it was Generes'. This case, then, is not the kind of case where it can

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tions, which the Supreme Court inferentially approved in Whipple v. C. I. R., 373 U.S. 193, 204, 83 S.Ct. 1168, 10 L.Ed. 2d 288 (1963). In the law of torts, where the notion of 'proximate' causation is most frequently encountered, a cause contributing to a harm may be found 'proximate' despite the fact that it might have been 'secondary' to another contributing cause." *Weddle v. Commissioner*, 325 F.2d 849, 851 (2d Cir. 1963).

be decided whether a controlling shareholder-employee in another kind of business may obtain an unwarranted deduction under Internal Revenue Code §166 (1954) simply because he employs himself in a company that he controls and can therefore claim that he personally backed the corporation financially because he wanted to receive income from his employment rather than augment his capital stake in the business. Reversal or affirmation of *Generes v. United States* by this Court cannot, because of its unique facts, clarify the law where clarification, if any, is needed by this Court and, therefore, review of the present case by this Court would not, when the opinion came to be written, serve the purpose for which the United States seeks issuance of the writ of certiorari.

CONCLUSION.

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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Brief for the United States

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